
Appendix A: Questions About Pay to Play

Questions About Pay To Play

1. Has the Federal Reserve or OCC made inquiries into the tying practices outlined with increasing frequency in the financial press? Have you issued any guidance or warnings to your member banks in the 2000-2002 time period or considered any hearings or investigations into these apparent violations of the law? If not, please explain your rationale for ignoring this problem.
2. To what degree is the pricing of credit being manipulated by commercial banks to build market share in investment banking business? Can the dramatic rise of commercial banks in the rankings of certain products such as investment grade debt underwriting be explained by anything other than tying?
3. Since it appears that credit is being offered as a loss leader by commercial banks to facilitate or leverage the expansion of their investment banking business, what are the implications of such mispricing on the supply of and demand for credit? What are the implications of this underpricing for the financial health of the smaller banks who participate in these syndicated facilities?
4. To what degree is this tying activity a cause of the increasing losses being realized by large banks on loans to borrowers such as Enron who were known to pay large investment banking fees? Is the "pay to play" practice leading to a concentration of bad credit risks among an increasingly smaller number of banks? What are the systemic implications of this distortion?
5. Does the current accounting model require commercial banks to record their liabilities, including loans and loan commitments, at fair value? Do the financial statements of major banks reflect the economic reality of the above-referenced mispriced credits and huge unrealized losses (and increasingly large realized losses) or are these financial statements misleading to investors?

Appendix B: Quotes from the Financial Press

The Tying of Credit

"Bank of America Corp., the second-biggest U.S. bank, **used its lending muscle to win investment-banking business from Potlatch Corp.** that propelled the bank into the top five arrangers of junk bonds for the first time . . . Potlatch wanted to include Bank of America because it **didn't want to risk losing its biggest lender**, said Gerald Zuehlke, treasurer and chief financial officer. The decision 'will keep them happier,' Zuehlke said in an interview. 'They've said they want more investment banking work.'"

— *Bloomberg*¹

"[The IPO of Agere out of Lucent] is the most extreme example we've seen so far of commercial banks using their lending muscle to displace traditional investment banks as underwriters . . . **It is pay to play.**"

— *Samuel Hayes, Professor of Finance, Harvard Business School*²

"Although **we are not interested in credit-only clients**, our ability to offer credit differentiates us from investment bank competitors who don't have our capital. Therefore, we think we are well positioned to grow this business with well rounded, robust client relationships featuring multiple products."

— *Ken Lewis, Chairman and CEO, Bank of America*³

"Admittedly, there is a fine line between providing clients a financial service and **buying banking business.**"

— *Seth Waugh, Chief Executive of Corporate Investment Banking, Deutsche Bank*⁴

"Bank of America Corp. turned down a request from Wal-Mart Stores Inc. to arrange a \$2.25 billion credit line because the world's biggest retailer hadn't hired the bank for investment banking business for six years. By turning down Wal-Mart, the second-largest lender in the U.S. is following through on a pledge made in December to reduce lending to customers that balk at hiring the bank to advise on acquisitions or manage bond and stock sales. Bank of America has arranged all Wal-Mart's credit lines since 1995."

— *Bloomberg*⁵

¹ Mark Lake, "Bank of America Uses Loans to Join Top Five Junk Underwriters," *Bloomberg* (June 19, 2001).

² Suzanne McGee, "Lucent Rewarded Lenders With Underwriter Roles," *Wall Street Journal* (February 28, 2001).

³ Goldman Sachs Banking and Financial Services Conference (December 6, 2000).

⁴ Gregg Wirth and Michelle Celarier, "Into the Crucible," *Investment Dealers' Digest* (June 11, 2001).

⁵ Mark Lake, "Bank of America Turns Down Wal-Mart for \$2.25 Bln Credit Line," *Bloomberg* (June 13, 2001).

The Tying of Credit

"David H. Komansky, Merrill's chairman, recently told the firm's brokers that the chief executive of a longtime client had notified him that Merrill would not handle the company's next stock offering. Next time around, Mr. Komansky said he was told, the unidentified **company planned to hire 'one of four or five commercial banks because they provided something like \$2 billion' in credit** to the company. Merrill officials declined to identify the company."

— *The New York Times*¹

"We are not interested in renting out our balance sheet to clients who are not delivering us additional fee-based business."

— *Jim Hance, Vice Chairman and Chief Financial Officer, Bank of America*²

"J.P. Morgan Chase, on the other hand, wants to cling to its competitive advantage as long as it can. **Providing low-cost multibillion-dollar loans** to companies such as Conoco Inc. and Procter & Gamble Co. **helped the bank beat out investment banks for more lucrative advisory roles.**"

— *Bloomberg*³

"There is a creeping capital intensity to the securities business that's being propelled by a handful of commercial banks who come to the table with very large balance sheets . . . **These five banks have more opportunity to use their balance-sheet muscle to get into the business.**"

— *Judah Kraushaar, Analyst, Merrill Lynch*⁴

"Our capital is precious, and lending is a thin-margin business . . . **We have to allocate it to a relationship that will yield benefits in the immediate future.**"

— *Martin G. McGuinn, Chairman and Chief Executive Officer, Mellon Financial Corp.*⁵

¹ Patrick McGeehan, "Banks Get Business at the Expense of Elite Firms," *New York Times* (June 15, 2001).

² Goldman Sachs Banking and Financial Services Conference (December 6, 2000).

³ Mark Lake, "J.P. Morgan Says Banks 'Eventually' Will Value Loans at Market," *Bloomberg* (June 8, 2001).

⁴ Patrick McGeehan, "Banks Get Business at the Expense of Elite Firms," *New York Times* (June 15, 2001).

⁵ Jathon Sapsford and Paul Sherer, "Fewer Banks Mean Costlier Credit Lines," *Wall Street Journal* (March 14, 2001).

Increasing Risks to the Financial System

"Loan capital is rising to the front and center of deals, and that can be **very dangerous to the parent company** of these commercial banks."

— *Samuel Hayes, Professor of Finance, Harvard Business School*¹

"For the past several years, the old Chase Manhattan, then the megabank formed by its \$25 billion purchase of J.P. Morgan & Co. last year, has **placed big bets** in its drive to use corporate-lending relationships as a way to break into the top tier of investment banking . . . Now, that **strategy has come back to haunt the bank**.

— *The Wall Street Journal*²

"**William Harrison, JP Morgan Chase chairman and chief executive, stood before 20 of Britain's most senior executives to proclaim his bank's work for Enron a triumph . . . Enron filed for bankruptcy two weeks later**, and JP Morgan subsequently acknowledged that its exposure to the energy trader was Dollars 2.6bn, rather than the Dollars 900m quantified initially in a press release."

— *Financial Times*³

"[T]here's little dispute that [Citigroup and J.P. Morgan Chase] have used their lending clout to gain underwriting business, which is less risky and typically more lucrative. Before Enron collapsed and the lawsuits started, for instance, lead banks J.P. Morgan and Citigroup were set to rake in some \$90 million in merger fees from its proposed merger with Dynegy Inc. **Alternately, banks always seem to get hurt on credit exposure**; in the 1980s the LDC crisis was followed by the real estate lending fiasco."

— *Investment Dealers' Digest*⁴

¹ Gregg Wirth and Michelle Celarier, "Into the Crucible," *Investment Dealers' Digest* (June 11, 2001).

² Paul Beckett and Jathon Sapsford, "Why J.P. Morgan Keeps Showing Up in the Wrong Place," *Wall Street Journal* (March 14, 2002).

³ Charles Pretzlik and Gary Silverman, "JP Morgan Bosses Feel the Heat After Enron," *Financial Times* (January 30, 2002).

⁴ Suzanne Miller, "A Tale of Two Banks," *Investment Dealers' Digest* (April 22, 2002).

Pricing of Credit

“Credit alone is not priced profitably . . . We are going to be far more diligent in how we look at our clients – partnership is a two way street.”

— *Jamie Dimon, Chairman and Chief Executive, Bank One*¹

“As the lending process moves closer to the capital markets process and as banks think more on a mark-to-market basis, they will price it with that kind of thought process . . . The marketplace will face **more appropriate pricing over time.”**

— *Sandy Weill, Chairman and CEO, Citigroup*²

“We’ve never said that holding loans is a great way to make money . . . Other banks, broadly speaking, are saying, ‘This is a product that doesn’t support itself very well.’ So all banks are saying, ‘Where else can we make money on this relationship?’”

— *Marc Shapiro, Vice Chairman, J.P. Morgan Chase*³

“Banks offer [credit] lines at a cost of a fraction of a cent for each dollar they commit. They accept such paltry fees to curry favour with management and win other assignments – most importantly, investment banking mandates . . . the combination of fewer banks taking on bigger hunks of debt in a tightening credit market is inevitably raising questions about systemic risk. **The rapid pace of business change is increasing the dangers of making long-term commitments to anyone.”**

— *Financial Times*⁴

¹ “The Cost of Leading Business into Temptation,” *Financial Times* (March 7, 2001).

² “The Cost of Leading Business into Temptation,” *Financial Times* (March 7, 2001).

³ Patrick McGeehan, “Banks Get Business at the Expense of Elite Firms,” *New York Times* (June 15, 2001).

⁴ “The Cost of Leading Business into Temptation,” *Financial Times* (March 7, 2001).

Shrinking Supply of Credit

"We are at a real crossroads . . . It is more difficult for higher-quality investment-grade companies to get all the capital they want."

— *Chad Leat, Head of Global Loans, Citigroup Salomon Smith Barney*¹

"We counsel our clients that the appetite for these types of facilities is challenged right now."

— *Suzanne Hammett, Head of Credit Risk Policy, J.P. Morgan Chase*²

"The irony is that it is becoming harder to put together large loan syndicates for well regarded companies . . . than it is for riskier operations facing heavier debt burdens."

— *Financial Times*³

"The dwindling group of major commercial banks, meanwhile, have more leverage than ever. After years of consolidation, there are only a few banks that can meet the borrowing needs of big domestic and global corporations. When those borrowers get into a financial bind, as many telecommunications and technology companies have in the last year, they are more inclined to try to appease the people whose loans are keeping them afloat."

— *The New York Times*⁴

¹ "The Cost of Leading Business into Temptation," *Financial Times* (March 7, 2001).

² "J.P. Morgan Pulling Back from Providing Standby Lines," *Bloomberg* (April 29, 2002).

³ "The Cost of Leading Business into Temptation," *Financial Times* (March 7, 2001).

⁴ Patrick McGeehan, "Banks Get Business at the Expense of Elite Firms," *New York Times* (June 15, 2001).
